**Annual Report on the Treasury Management Service and Actual Prudential Indicators for 2017/18**

**Summary**

**Report to advise members of the Treasury Management Service performance and to illustrate the compliance with the Prudential Indicators for 2017/18**

**Recommendation**

**The Performance and Finance Scrutiny Committee is asked to NOTE the report on Treasury Management including compliance with the 2017/18 Prudential Indicators;**

## 1. RESOURCE IMPLICATIONS

1.1 None directly as a result of this paper, but the Authority is heavily dependent on investment income to support its current revenue expenditure. The table below shows investment income from treasury activities (excluding Iceland) from 2013/14 to 2017/18.

1.2

| Year | Investment income from treasury activities | Increase/decrease compared to previous year | |
|---|---|---|---|
| | £'000 | £0 | % |
| 2013/14 | 208 | -92 | -42.80% |
| 2014/15 | 273 | 35 | 17.00% |
| 2015/16 | 515 | 242 | 88.80% |
| 2016/17 | 488 | -27 | -5.30% |
| 2017/18 | 165 | -323 | -66.20% |

1.3 Treasury income returns decreased in 2017/18 due to the continuing low interest rate environment nationally coupled with the redemption of investments to repay borrowing.

## 2. KEY ISSUES

2.1 The Authority's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management ("the Code"), which requires authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities at least twice a year. This report informs members of the outcome of treasury activities in the last year and a further report later in the year will report on the first 6 months.

2.2 Treasury management is defined as: "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.3 The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds, and the revenue effect of changing interest rates. Overall responsibility for treasury management remains with the Council. No treasury management activity is without risk; the effective identification and management of risk are integral to the Council's treasury management strategy.

2.4 This report is the annual report for the 2017/18 financial year. It includes both a summary of treasury management performance during the year as well demonstrating compliance with the 2017/18 Prudential Indicators.

2.5 This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Ministry of Housing, Communities and Local Government) (MHCLG) Investment Guidance, and the CIPFA Prudential Code for Capital Finance in Local Authorities. In December 2017, CIPFA published revised editions of the Treasury Management and Prudential Codes. The Ministry of Housing, Communities and Local Government also published a revised Guidance on Local Government and Investments and Statutory Guidance on Minimum Revenue Provision (MRP).

2.6 Detail of Other Local Authority regulatory changes are shown in note 5.6.

2.7 The required changes from the 2011 Code are being incorporated into Treasury Management Strategies and monitoring reports.

2.8 The Council borrowed externally to purchase property and the impact of this is included within this report.

2.9 The Council does not have any Lender option Borrower option loans (LOBOs) on its books, all borrowing has either being via the public works loan board (PWLB) or other local authorities.

## 3. SUPPORTING INFORMATION

### Treasury Management Strategy 2017/18

3.1 The Council approved the 2017/18 Treasury Management Strategy, which includes the investment strategy, at its meeting on the 22nd February 2017. All treasury management activity complied with the approved treasury management strategy, the CIPFA Code of Practice and the relevant legislative provisions. Further amendments to the strategy to increase the Council's borrowing limit were approved on 20th June 2017 and 1st August 2017.

### Investment Strategy 2017/18

3.2 The approved investment strategy for 2017/18 adopted a view to investment that sought to balance risk against return. It maintained a policy, on the advice of our treasury advisers Arlingclose, of diversifying investments including longer term investment funds which give a good return but can be more volatile. The Council maintained its longer term investment in the CCLA Property Fund. The CCLA Property fund aims to provide investors with a high level of income and long term capital appreciation through investment principally in a diversified portfolio of UK commercial property but it may invest in other assets.

3.3 The Council continued to use a limited range of UK banks and building societies with investments being placed generally for short periods only. This was not only because of the poor rates offered but also the risk of bail in due to changes in legislation in 2016. A bail-in is rescuing a financial institution on the brink of failure by making its creditors and depositors take a loss on their holdings. A bail-in is the opposite of a bail-out, which involves the rescue of a financial institution by external parties, typically governments using taxpayers' money.

**Borrowing Strategy 2017/18**

3.4 The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31st March 2018 was £142.2m (140.2m at 31st March 2017).

3.5 The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

**Other Local Authority Regulatory Changes**

3.6 Revised CIPFA Codes

CIPFA published revised editions of the Treasury Management and Prudential Codes in December 2017. The required changes from the 2011 Code are being incorporated into Treasury Management Strategies and monitoring reports.

The 2017 Prudential Code introduces the requirement for a Capital Strategy which provides a high-level overview of the long-term context of capital expenditure and investment decisions and their associated risks and rewards along with an overview of how risk is managed for financial sustainability over the longer term. Where this strategy is produced and approved by Full Council, the determination of the Treasury Management Strategy can be delegated to a committee. The Capital Strategy will be delegated to the Executive in February 2019. The Code also expands on the process and governance issues of capital expenditure and investment decisions.

In the 2017 Treasury Management Code the definition of 'investments' has been widened to include financial assets as well and non-financial assets held primarily for generating income returns such as investment property. These, along with other investments made for non-treasury management purposes such as loans supporting service outcomes and investments in subsidiaries, must be discussed in the Capital or Investment Strategy. The additional risks of such investments are to be set out clearly and the impact on financial sustainability is to be identified and reported.

3.7 MHCLG Investment Guidance

In February 2018 the MHCLG (Ministry of Housing, Communities and Local Government) published revised Guidance on Local Government and Investments. The changes include a wider definition of investments to include non-financial assets held primarily for generating income return and a new category called "loans" (e.g. temporary transfer of cash to a third party, joint venture, subsidiary or associate). The Guidance introduces the concept of proportionality, proposes additional disclosure for borrowing solely to invest and also specifies additional indicators. Where the Council relies on investment income to achieve a balanced budget and fund core services, the extent of this must be disclosed in the Investment Strategy together with contingency plans should yields on investments fall.

3.8 Minimum Revenue Provision

The definition of prudent MRP has been changed to “put aside revenue over time to cover the CFR”; it cannot be a negative charge and can only be zero if the CFR is nil or negative. (CFR is Capital Financing Requirement and it measures the Council’s underlying need to borrow or finance by other long term liabilities for capital purposes) Guidance on asset lives has been updated, applying to any calculation using asset lives. Any change in MRP policy cannot create an overpayment; the new policy must be applied to the outstanding CFR going forward only.

3.9 MiFID II

As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met which includes having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the council have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

The Council has met the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. The Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

3.10 Treasury Advisers

The Council uses Arlingclose Limited as its treasury management advisers to provide advice on all aspects of treasury management including interest rate forecasts, counterparty lists and management advice. They have provided an Economic Review, counterparty update and market data by way of background information and this is included in Annex C.

**BORROWING AND INVESTMENT ACTIVITY IN 2017/18**

**Borrowing Activity 2017/18**

3.11 At 31/03/2018 the Authority’s underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £142.2m, while usable reserves and working capital which are the underlying resources available for investment were £31.2m on an accruals basis.

3.12 At 31/03/2018, the Authority had £119.7m (£118.9m at 31 March 2017) of borrowing and £14.9m (£11.5m at 31 March 2017) of treasury investments. The Authority’s current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing, subject to holding a minimum short-term investment balance of £5m.

3.13 The majority of the Authority’s borrowing was short term loans. This strategy enabled the Authority to reduce borrowing costs.

3.14 However, to enable certainty of cost, the Authority arranged £50million of forward starting loans during 2017/18. In 2020/21 a loan of £25million with a fixed interest rate of 2.853% will be advanced to the Authority. In 2021/22, a further loan of £25milion with a fixed interest rate of 2.908% will be advanced. Both loans will be repayable over 40 years.

3.15 The Authority is predicted to have an increasing CFR over the next year due to the capital programme of up to £23m, the majority of which is future property acquisitions.

3.16 During the year the Authority entered in to £1.1m of new short term borrowing. The details are given in the table below:

| | **31.03.17 Balance £m** | **2017/18 Movement £m** | **31.03.18 Balance £m** | **31.03.18 Rate %** |
|---|---|---|---|---|
| Public Works Loan Board | -16.4 | 0.1 | -16.3 | 2.9 |
| Local authorities (long term) | -1.0 | 0.2 | -0.8 | 0.0 |
| Local authorities (short term) | -101.5 | -1.1 | -102.6 | 0.4 |
| **Total Borrowing** | -119.0 | -0.7 | -119.7 | 1.1 |

3.17 The outturn for debt interest paid in 2017/18 was £0.9m on an average debt portfolio of £119.7m.

**INVESTMENT ACTIVITY 2017/18**

3.18 The Authority held invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2017/18 the Authority's average investment balance was £12 million. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Authority's aim is to achieve a yield commensurate with these principles.

3.19 The table below shows a summary of the investment activity for 2017/18:

| Investment Counterparty | Balance on 01/04/17 | Investments Made | Maturities/ Investments Sold | Balance on 31/03/18 | Average Rate at 31st March |
|---|---|---|---|---|---|
| | £000s | £000s | £000s | £000s | % |
| **UK Central Government** | | | | | |
| - Short Term | **0** | 70,300 | -70,300 | **0** | 0.25 |
| - Long Term | **0** | 0 | 0 | **0** | - |
| **UK Local Authorities** | | | | | |
| - Short Term | **2,000** | 0 | -2,000 | **0** | 0.35 |
| - Long Term | **2,000** | 0 | 0 | **2,000** | 1.30 |
| **Banks, Building Societies & Other Organisations** | | | | | |
| - Short Term | **5,434** | 81,256 | -85,657 | **1,032** | 0.20 |
| - Long Term | **0** | 0 | 0 | **0** | - |
| **AAA-rated Money Market Funds** | | | | | |
| - Short Term Cash Equivalents | **0** | 60,023 | -50,271 | **9,752** | 0.42 |
| - Long Term | **2,054** | 97 | 0 | **2,151** | 4.82 |
| **Total Investments** | **11,488** | **211,677** | **-208,229** | **14,935** | **1.22** |

3.20 Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

3.21 Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy for 2017/18.

3.22 Counterparty credit quality was assessed and monitored by our advisers with reference to ratings (the Authority's minimum long-term counterparty rating is A across rating agencies Fitch, S&P and Moody's).

3.23 Investments held during the year included:

- Deposits with the Debt Management Office
- Deposits with Other Local Authorities
- Investments in AAA-rated constant and variable net asset value Money Market Funds
- Call accounts and deposits with Banks and Building Societies in the UK

3.24 The Authority's current accounts, together with a Business Reserve Account are held with NatWest plc who does not currently meet the above credit rating criteria (stated in note 5.17). The Authority will treat NatWest plc as "high credit quality" for the purpose of making investments that can be withdrawn on the next working day.

**Credit Risk**

3.25 Counterparty credit quality as measured by credit ratings is summarised below:

| Date | Value Weighted Average – Credit Risk Score | Value Weighted Average – Credit Rating | Time Weighted Average – Credit Risk Score | Time Weighted Average – Credit Rating |
|---|---|---|---|---|
| 31/03/2015 | 3.74 | AA- | 2.79 | AA |
| 31/03/2016 | 4.26 | AA- | 2.35 | AA |
| 31/03/2017 | 4.99 | A+ | 3.06 | AA |
| 31/03/2018 | 4.42 | AA- | 3.65 | AA- |

*Scoring:*
*-Value weighted average reflects the credit quality of investments according to the size of the deposit*
*-Time weighted average reflects the credit quality of investments according to the maturity of the deposit*
*-AAA = highest credit quality = 1*
*- D = lowest credit quality = 26*
*-Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security*

**Budgeted Income and Outturn**

3.26 The average cash balances during the year was £12m. The Authority's best performing investment in 2017/18 was the externally managed CCLA Property Fund where £2m was held. This investment generated a total return of £0.19m (9.79%), comprising a £0.13m (4.82%) income return used to support services in year, and £0.06m (4.97%) of capital growth. Because this fund has no defined maturity date, but is available for withdrawal after a notice period, its performance and continued stability in meeting the Authority's investment objectives is regularly reviewed. In light of its strong income generation performance, investment in this fund has been maintained for the 2018/19 financial year.

3.27 The Authority's budgeted investment income for the year was £0.30m and the outturn was £0.17m. This was mainly due to actual interest rates being lower than expected. The shortfall was covered by the interest rate equalisation reserve.

**Externally Managed Funds**

3.28 The Authority maintained its investment in the CCLA Property fund. The property fund which is operated on a variable net asset value (VNAV) basis offers diversification of investment risk, coupled with the services of a professional fund manager; it also offers enhanced returns over the longer term but is more volatile in the short-term. The Authority's CCLA property fund is in the distributing share class which pays out the income generated.

**Compliance with Prudential Indicators**

3.29 The Authority can confirm that it has complied with its Prudential Indicators for 2017/18 which were approved on 22nd February 2017 by Full Council as part of the Council's Treasury Management Strategy Statement. Further amendments to the strategy to increase the Authority's borrowing limit were approved on 20th June 2017 and 1st August 2017.

3.30 In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2017/18. None of the Prudential Indicators have been breached and a prudent approach has been taking in relation to investment activity with priority being given to security and liquidity over yield.

**Borrowing Strategy for 2018/19 and beyond**

3.31 In order to take advantage of low interest rates, the Authority continued to borrow short term from other public bodies rather than longer term from the PWLB as advised by its Treasury advisers. In 2017/18, on the advice of the Treasury advisors, the Authority arranged forward starting loans amounting to £50m. The cash will be advanced in equal amounts in 2020/21 and 2021/22 and will be repayable over 40 years. This will minimise the interest rate risk.

## 4. CORPORATE OBJECTIVES AND KEY PRIORITIES

4.1 This report demonstrates how treasury management supports Key priority 2.

## 5. POLICY FRAMEWORK

5.1 The 2017/18 Annual Investment Strategy together with the Treasury Management Strategy was approved by Full Council on 22nd February 2017. These set out the parameters under which Treasury Management operates including the Prudential Indicators.

5.2 The Council fully complies with the requirements of the CIPFA Code of Practice on Treasury Management. The relevant criteria and constraints incorporated into the Treasury Management Policy Statement are:

- New borrowing is contained within the limits approved by the Council, in accordance with the CIPFA Prudential Code for Capital Finance in Local Authorities, and the Council's Prudential Indicators.

- Investments are made in accordance with the MHCLG guidance on Local Authority Investments, on the basis of Fitch, Moody's and Standard & Poor's credit ratings and as detailed in the Treasury Management Policy statement and approved schedules and practices.

- Sufficient funds are available to meet the Council's estimated outgoings for any day.

- Investment objectives are to maximise the return to the Council, subject to the overriding need to protect the capital sum.

## 6. LEGAL ISSUES

6.1 The Authority is required to comply with the Prudential Code as laid down by the Government.

## 7. RISK MANAGEMENT

7.1 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. The key treasury risks being managed are:

- credit risk,
- liquidity risk,
- interest rate risk,
- refinancing risk, and
- operational risk.

The techniques employed to manage these risks are covered in detail in the Council's Treasury Management Practices, and include:

- robust counterparty monitoring and selection criteria,
- prudent cash flow forecasting,
- a range of exposure limits and indicators, and
- procedures designed to prevent fraud and error.

7.2 The Council's primary objectives for the management of its investments are to give priority to the security and liquidity of its funds before seeking the best rate of return.

7.3 The limits applied in respect of counterparties and investments are the overall limits approved by Council in the annual Treasury Management Strategy. However from time to time these may be tightened temporarily by the Executive Head of Finance in consultation with the Portfolio Holder for Finance to reflect increased uncertainty and increase in perceived risk in financial institutions and the economy. This will usually be at the cost of lower returns.

7.4 It should be noted that the investments ratings provided by credit ratings agencies are only a guide and do not give 100% security. There is always a risk that an institution may be unable to repay its loans whatever the credit rating

7.5 The Council measures its exposures to treasury management risks using a range of indicators as recommended by the CIPFA Code of Practice on Treasury Management.

| | |
|---|---|
| **Annexes** | Annex A – Investments as at 31st March 2018<br>Annex B - Compliance with Prudential Indicators<br>Annex C – Economic and other background information from Arlingclose Limited. |
| **Background Papers** | CIPFA Code of Practice: Treasury Management in the Public Services – 2011 Edition<br>CIPFA Code of Practice: Treasury Management in the Public Services – 2018 Edition |
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**ANNEX A**

# Treasury Related Investment Balances as at 31st March 2018

| Investments | Notes | Maturity Date | Interest Rate % | Principal |
|---|---|---|---|---|
| | | | | £ |
| **Cash and Cash Equivalents** | | | | |
| Banks | | | | |
| NatWest Business Reserve Account | On call | | 0.01 | 100,069 |
| NatWest Central Account | | | 0.01 | 932,196 |
| Money Market Funds | | | | |
| BlackRock | | | variable | 2,750,000 |
| CCLA Public Sector Deposit Fund | | | variable | 1,000,000 |
| Legal and General | | | variable | 3,000,000 |
| Standard Life Investments | | | variable | 3,000,000 |
| **Total Cash and Cash Equivalents** | | | | **10,782,265** |
| **Long Term Investments** | | | | |
| **Loans and Receivables** | | | | |
| Glasgow City Council | | 30-Oct-18 | 1.30 | 2,000,000 |
| **Available for Sale** | | | | |
| CCLA Property Fund | | Long term | 4.82 | 2,151,135 |
| **Total Long Term Investments** | | | | **4,151,135** |
| **Total Investments** | | | | **14,933,400** |

**ANNEX B**

## Compliance with Prudential Indicators

The Authority confirms compliance with its Prudential Indicators for 2017/18 which were set in February 2017 then subsequently amended in June 2017 and August 2017.

### Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

**Interest Rate Exposures:** This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount of net principal borrowed:

| | **31.3.18 Actual** | **2017/18 Limit** |
|---|---|---|
| Upper limit on fixed interest rate exposure | £0.5m | £2.8m |
| Upper limit on variable interest rate exposure | £0.23m | £0m |

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

**Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

| | **31.3.18 Actual** | **2017/18 Target** |
|---|---|---|
| Portfolio average credit rating | AA- | A |

**Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing. The Authority also has the option to borrow on a daily basis on the open market.

| | **31.3.18 Actual** | **2017/18 Target** |
|---|---|---|
| Total cash available within 3 months | £6m | £5m |

**Maturity Structure of Borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing were:

| | **31.08.18 Actual** | **Upper limit** | **Lower limit** |
|---|---|---|---|
| Under 12 months | 86% | 100% | 0% |
| 12 months and within 24 months | 0 | 100% | 0% |
| 24 months and | 2% | 100% | 0% |

| within 5 years | | | |
|---|---|---|---|
| 5 years and within 10 years | 1% | 100% | 0% |
| 10 years and above | 11% | 100% | 0% |

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

**Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

| | **2017/18** | **2018/19** | **2019/20** |
|---|---|---|---|
| Actual principal invested beyond year end | £2m | £2m | £2m |
| Limit on principal invested beyond year end | £15m | £15m | £15m |

**Prudential Indicators 2017/18**

The Local Government Act 2003 requires the Authority to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

| Capital Expenditure and Financing | 2017/18 Actual | 2017/18 Estimate | 2018/19 Estimate |
|---|---|---|---|
| | £m | £m | £m |
| Capital Program | 4.4 | 12.6 | 8.6 |
| **Total Expenditure** | 4.4 | 12.6 | 8.6 |
| Capital Receipts | 0.2 | 0.1 | 0.1 |
| Government Grants | 0.6 | 0.6 | 3.1 |
| Reserves | 0.2 | - | - |
| Revenue | 0.1 | - | - |
| Borrowing | 3.3 | 12.0 | - |
| **Total Financing** | **-** | **-** | **5.5** |

**Estimates of Capital Financing Requirement:** The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose.

| | **31.03.18 Actual £m** | **31.03.18 Estimate £m** | **31.03.19 Estimate £m** |
|---|---|---|---|
| **Capital Financing Requirement** | **142** | **144** | **150** |

**Gross Debt and the Capital Financing Requirement:** In order to ensure that over the medium term debt will only be for a capital purpose, the Authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

| **Debt** | **31.03.18 Actual** | **31.03.18 Estimate** | **31.03.19 Estimate** |
|---|---|---|---|
| | £m | £m | £m |
| Borrowing | 120 | 124 | 133 |
| Capital Financing Requirement | 142 | 144 | 150 |
| **Headroom** | **22** | **20** | **17** |

The figures above could increase significantly if the council decides to invest in more property.

The actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt, below.

**Operational Boundary for External Debt:** The operational boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt.

| **Operational Boundary** | **2017/18 £m** | **2018/19 £m** | **2019/20 £m** |
|---|---|---|---|
| Borrowing | 185 | 185 | 185 |
| **Total Debt** | **185** | **185** | **185** |

**Authorised Limit for External Debt:** The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

| **Authorised Limit** | **2017/18 £m** | **2018/19 £m** | **2019/20 £m** |
|---|---|---|---|
| Borrowing | 190 | 190 | 190 |
| **Total Debt** | **190** | **190** | **190** |

Should the Council decide to borrow to invest in property members would be asked to increase the limits above at that time.

**Ratio of Financing Costs to Net Revenue Stream:** This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

| Ratio of Financing Costs to Net Revenue Stream | 2017/18 Actual % | 2017/18 Estimate % | 2018/19 Estimate % |
|---|---|---|---|
| General Fund | **-2.6** | **-2.0** | **0.9** |

**Incremental Impact of Capital Investment Decisions:** This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed earlier in this report.

| Incremental Impact of Capital Investment Decisions | 2016/17 Actual £ | 2017/18 Estimate £ | 2018/19 Estimate £ |
|---|---|---|---|
| General Fund - increase in annual Band D Council Tax | 3.38 | 30.81 | 1.63 |

**Adoption of the CIPFA Treasury Management Code:**
The Council approved the adoption of the CIPFA Treasury Management Code at its meeting on 22nd February 2017.

**ANNEX C**

**ECONOMIC REVIEW, COUTERPARTY UPDATE AND MARKET DATA PROVIDED BY ARLINGCLOSE LIMITED (July 2018)**

**Economic Review**

2017-18 was characterised by the push-pull from expectations of tapering of Quantitative Easing (QE) and the potential for increased policy rates in the US and Europe and from geopolitical tensions, which also had an impact.
The UK economy showed signs of slowing with latest estimates showing GDP, helped by an improving global economy, grew by 1.8% in calendar 2017, the same level as in 2016. This was a far better outcome than the majority of forecasts following the EU Referendum in June 2016, but it also reflected the international growth momentum generated by the increasingly buoyant US economy and the re-emergence of the Eurozone economies.

The inflationary impact of rising import prices, a consequence of the fall in sterling associated with the EU referendum result, resulted in year-on-year CPI rising to 3.1% in November before falling back to 2.7% in February 2018. Consumers felt the squeeze as real average earnings growth, i.e. after inflation, turned negative before slowly recovering. The labour market showed resilience as the unemployment rate fell back to 4.3% in January 2018. The inherent weakness in UK business investment was not helped by political uncertainty following the surprise General Election in June and by the lack of clarity on Brexit, the UK and the EU only reaching an agreement in March 2018 on a transition which will now be span Q2 2019 to Q4 2020. The Withdrawal Treaty is yet to be ratified by the UK parliament and those of the other 27 EU member states and new international trading arrangements are yet to be negotiated and agreed.

The Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 0.25% in November 2017. It was significant in that it was the first rate hike in ten years, although in essence the MPC reversed its August 2016 cut following the referendum result. The February *Inflation Report* indicated the MPC was keen to return inflation to the 2% target over a more conventional (18-24 month) horizon with 'gradual' and 'limited' policy tightening. Although in March two MPC members voted to increase policy rates immediately and the MPC itself stopped short of committing itself to the timing of the next increase in rates, the minutes of the meeting suggested that an increase in May 2018 was highly likely.

In contrast, economic activity in the Eurozone gained momentum and although the European Central Bank removed reference to an 'easing bias' in its market communications and had yet to confirm its QE intention when asset purchases end in September 2018, the central bank appeared some way off normalising interest rates.
The US economy grew steadily and, with its policy objectives of price stability and maximising employment remaining on track, the Federal Reserve Open Market Committee (FOMC) increased interest rates in December 2017 by 0.25% and again in March, raising the policy rate target range to 1.50% - 1.75%. The Fed is expected to deliver two more increases in 2018 and a further two in 2019. However, the imposition of tariffs on a broadening range of goods initiated by the US, which has led to retaliation by China, could escalate into a deep-rooted trade war having broader economic consequences including inflation rising rapidly, warranting more interest rate hikes.

**Financial markets**

The increase in Bank Rate resulted in higher money markets rates: 1-month, 3-month and 12-month LIBID rates averaged 0.32%, 0.39% and 0.69% and at 31st March 2018 were 0.43%, 0.72% and 1.12% respectively.

Gilt yields displayed significant volatility over the twelve-month period with the change in sentiment in the Bank of England's outlook for interest rates. The yield on the 5-year gilts which had fallen to 0.35% in mid-June rose to 1.65% by the end of March. 10-year gilt yields also rose from their lows of 0.93% in June to 1.65% by mid-February before falling back to 1.35% at year-end. 20-year gilt yields followed an even more erratic path with lows of 1.62% in June, and highs of 2.03% in February, only to plummet back down to 1.70% by the end of the financial year.

The FTSE 100 had a strong finish to calendar 2017, reaching yet another record high of 7688, before plummeting below 7000 at the beginning of 2018 in the global equity correction and sell-off.

**Credit background:**

Credit Metrics
In the first quarter of the financial year, UK bank credit default swaps reached three-year lows on the announcement that the Funding for Lending Scheme, which gave banks access to cheaper funding, was being extended to 2018. For the rest of the year, CDS prices remained broadly flat.

The rules for UK banks' ring-fencing were finalised by the Prudential Regulation Authority and banks began the complex implementation process ahead of the statutory deadline of 1st January 2019. As there was some uncertainty surrounding which banking entities the Authority would will be dealing with once ring-fencing was implemented and what the balance sheets of the ring-fenced and non ring-fenced entities would look would actually look like, in May 2017 Arlingclose advised adjusting downwards the maturity limit for unsecured investments to a maximum of 6 months. The rating agencies had slightly varying views on the creditworthiness of the restructured entities.

Barclays was the first to complete its ring-fence restructure over the 2018 Easter weekend; wholesale deposits including local authority deposits will henceforth be accepted by Barclays Bank plc (branded Barclays International), which is the non ring-fenced bank.

**Money Market Fund regulation**
The new EU regulations for Money Market Funds (MMFs) were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility Net Asset Value (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

**Credit Rating developments**

The most significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities.

Changes to credit ratings included Moody's downgrade of Standard Chartered Bank's long-term rating to A1 from Aa3 and the placing of UK banks' long-term ratings on review to reflect the impending ring-fencing of retail activity from investment banking (Barclays, HSBC and RBS were on review for downgrade; Lloyds Bank, Bank of Scotland and National Westminster Bank were placed on review for upgrade).

Standard & Poor's (S&P) revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings, reflecting the institutions' resilience, progress in meeting regulatory capital requirements and being better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019. The agency upgraded Barclays Bank's long-term rating to A from A- after the bank announced its plans for its entities post ring-fencing.

Fitch revised the outlook on Nationwide Building Society to negative and later downgraded the institution's long-term ratings due to its reducing buffer of junior debt. S&P revised the society's outlook from positive to stable.

S&P downgraded Transport for London to AA- from AA following a deterioration in its financial position.

**Other developments**

In February, Arlingclose advised against lending to Northamptonshire County Council (NCC). NCC issued a section 114 notice in the light of severe financial challenge and the risk that it would not be in a position to deliver a balanced budget.

In March, following Arlingclose's advice, the Authority removed RBS plc and National Westminster Bank from its counterparty list. This did not reflect any change to the creditworthiness of either bank, but a tightening in Arlingclose's recommended minimum credit rating criteria to A- from BBB+ for FY 2018-19. The current long-term ratings of RBS and NatWest do not meet this minimum criterion, although if following ring-fencing NatWest is upgraded, the bank would be reinstated on the Authority's lending list.